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Policy Changes Spell Stronger Yen Ahead

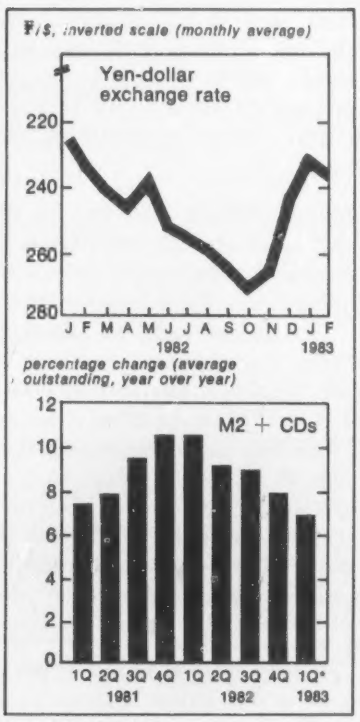
Without fanfare, an important shift in Japanese economic policy appears to be taking place. Over the past year, the government has maintained a restrictive fiscal stance in hopes of eliminating the need to issue deficit-covering national bonds by fiscal 1984. Monetary policy, on the other hand —at least through the first half of 1982—was highly expansionary in an effort to spur weak domestic demand. This resulted in lower real interest rates in Japan than in the United States or Europe, which in turn led to a sizable net outflow of capital, a large loss of reserves, and a sharp depreciation of the yen. The second quarter of 1982 saw a striking improvement in real growth, but all other signs pointed to a continued lackluster economy.

Nevertheless, criticism from the West that the weak yen was giving Japanese exports an "unfair" competitive advantage forced a retreat from the stimulative monetary stance. Beginning last spring, the monetary authorities adopted a progressively less expansionary policy. And although the yen enjoyed a dazzling appreciation from mid-November to mid-January, this tempered policy position appears to have been carried over into 1983. For the first quarter, the Bank of Japan is aiming to keep growth in M2 plus certificates of deposit at an annual rate of just 7%—not a particularly expansionary target, given the likely growth in nominal income and the historically downward trend in velocity.

In addition, Japanese policymakers now appear to be considering a more expansive fiscal policy. The sluggish growth of recent years has forced the government to concede that its goal of balancing the budget by fiscal 1984 cannot realistically be achieved. And because of political considerations, as well as concern about the domestic economy, an income-tax cut has just been promised for fiscal 1983.

Given the government's persistent problems in selling its national bonds, unless taxes on oil are increased it is difficult to see how income taxes can be cut substantially this year without first laying the groundwork for a new tax to offset the revenue loss. Moreover, although the yen has leveled off for the moment, further appreciation seems inevitable as soon as (a) the oil-price uncertainty subsides and (b) the foreign-exchange market realizes that the United States is likely to pursue a more relaxed monetary policy for several more months. This could spur an easing by the Japanese monetary authorities once again. If, however, the current trend toward a more-stimulative fiscal policy and a less-expansionary monetary policy continues, the yen could strengthen even more than many forecasters are predicting.

The value of the yen and Japanese monetary growth



*government target

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Current-account deficit a possibility for Norway in 1983.

Falling oil prices have prompted further downward revisions of 1983 forecasts for the Norwegian economy. GDP this year is now expected to remain at 1982's level, while the current account is likely to show a small deficit after the series of surpluses enjoyed since 1980. Contrary to its neighbor in the North Sea—the United Kingdom—Norway's currency has not dropped much as oil prices have fallen. Consequently, there is a good chance that domestic inflation will be reduced from its current 10.1% as lower oil prices work through the economy. Reduced oil prices can be expected to lead to declines in Norway's income and its wealth, but estimates suggest that even the country's more expensive fields in terms of production costs would be profitable at a price as low as $20 per barrel. As a result, Norway should continue to reap a substantial benefit from its oil production. The main issue for the future is the government's reaction to the changed economic situation. For some years, the booming oil sector has tended to overheat the economy. This has generated domestic inflation—11.1% at an annual rate in 1982 on the heels of 1981's 13.6%—and reduced the competitiveness of Norway's traditional industries. The slowdown in the oil sector should provide an opportunity to beat inflation. However, signs are already growing that—following its usual stance of aiming for full, if not over full, employment—the government will introduce countercyclical policies. This suggests that even if inflation moderates somewhat, it will remain high by international standards. It also gives further credence to forecasts of a current-account deficit.

Falling oil prices raise hopes for Italy's current-account balance.

Italy's 1982 current-account deficit is officially estimated to have declined to $5.5 billion from over $8 billion in 1981. Data are not yet available to ascertain how much of the improvement was attributable to volume effects. But preliminary evidence suggests that the bulk of the change was due to an improvement in Italy's terms of trade, as commodity prices fell relative to prices for manufactured goods. The Bank of Italy projects that the deficit will halve in 1983, owing to lower oil prices, lower interest rates on the country's external debt, and slower growth in Italy than in the rest of Europe. If, however, oil prices decline by 20% or more, the improvement could be still greater than forecast: Each 10% fall in oil prices reduces Italy's net oil bill by some $1.9 billion; even a small surplus is possible. This, in turn, would allow the authorities to follow more expansionary economic policies.

Greek policymakers hoping to boost growth, contain current-account deficit in 1983.

Despite some modest gains, 1982 was another difficult year for the Greek economy. Consumer price inflation officially fell to around 20% from 24% in 1981. But according to the latest available data, during the first eleven months of the year, real GDP stagnated while industrial production declined by some 4.5%. The current-account deficit is estimated to have fallen to just under $2 billion (over 5% of GDP), from $2.4 billion in 1981. This improvement, however, hides an underlying deterioration—the narrowing of the deficit was entirely due to a rundown of oil stocks that cannot be repeated in 1983. Even more troublesome in the external accounts is the estimated 27% decline in private capital inflows. This forced increased official borrowing but nonetheless led to a $160-million loss in official reserves. For 1983, policymakers are hoping that the combination of a reflationary fiscal policy, wage and price controls, the recent 15.5% devaluation of the drachma, selective import controls, and a recovery in the rest of Europe will spur stronger GDP growth and help contain the current-account deficit.

Burma depending on commodity-price rebound to turn economy around.

The Burmese economy faltered last year after four years of rapid advance from 1978 through 1981, during which GDP growth averaged almost 7% per year. GDP growth in 1982 was probably not over 4%, and economic activity may still be slowing down. The country has run into two quite separate problems. For one, it is sharing the world recession and has suffered a setback from serious declines in the prices of its main exports—particularly rice—which normally provide nearly half of total export earnings. Foreign exchange reserves fell to $89 million last year from $229 million a year earlier, despite borrowings of

some SDR 25.6 million (about $28 million) from the IMF's Compensatory Financing Facility. The second problem has been the decline in the output of oil from Burma's only major source—the onshore Mann Field, north of Rangoon. The Burmese government has not yet revealed the extent of the decline, but observers believe that output is now down to around 22,000 b/d from a 1980/81 peak of around 30,000 b/d—a drop on the order of 3 million barrels a year. Shortages of fuel are affecting both transportation and industry. The problem could be resolved by imports, but the government has not yet decided on the course. In any case, imports of the magnitude apparently required would strain the country's limited exchange resources. Offshore exploration by a Japanese consortium may eventually provide new sources of oil and gas, but in the short run, a revival of world commodity prices offers the best hope of relief for Burma's troubles.

Peruvian economic performance in 1982 fell short of most goals.

Peru's economy did not show the improvement in 1982 the authorities had envisaged when they embarked on an IMF-supported stabilization program at mid-year. Instead of the 60% inflation rate and 4% real growth that had been expected, inflation remained at a rate of 73% for the second year in a row and economic activity stagnated. The current-account deficit was virtually on target at $1.4 billion, thanks to the poor economic growth, a rapid acceleration in the monthly devaluation rate, and the reimposition of certain import controls. Efforts to meet the fiscal targets that had been set were not so successful, however. Policymakers had aimed to reduce the public-sector deficit to the equivalent of 4.2% of GDP from 8.6% in 1981; it was lowered to only 6.6%. But what is perhaps most disappointing is that Peru technically remained in compliance with the IMF program by resorting to a financing scheme that circumvented the targets established by the Fund to measure fiscal progress. This is unfortunate since a substantial reduction in the budget deficit is crucial to Peru's achieving a sustainable improvement in its external position.

Malaysia aiming to become major LNG exporter.

Independent of its position as an oil exporter, Malaysia's stake in stable-to-higher oil prices took on increased importance with the departure of its first liquified natural gas (LNG) shipment to Japan at the end of January. Malaysia now ranks fifth in the world in terms of its deposits of natural gas, with reserves estimated at between 33 trillion and 45 trillion cubic feet. The government is planning to use part of the gas as feedstock for a wide range of development projects but also aims to become a major LNG exporter. Under a 20-year sales agreement signed with the Japanese, Malaysia is committed to shipping 6 million tons of LNG a year to Japan once the production from the major Bintulu plant reaches full capacity in 1985. With the landed price of LNG under the contract tied closely to the average government selling price of crude oil to Japan, the amount of foreign exchange derived from these exports will depend crucially on the behavior of oil prices.

Saudi Arabia's current account expected to move into deficit.

Saudi Arabia's current-account surplus fell markedly last year from 1981's record level of $45.1 billion. The contraction stemmed from the kingdom's sharp cutbacks in oil output in what proved to be an unsuccessful attempt to defend the OPEC price structure. Saudi production dropped 34% in 1982 to a daily average of 6.45 million b/d, causing a 31% decline in merchandise export revenues to an estimated $77 billion. At the same time, imports of goods and services rose by about 13% to $81 billion, and private, as well as official, transfer payments came to about $9 billion. Taking into account service exports of around $18 billion—nearly three-fourths of which were foreign investment income—last year's surplus dwindled to an estimated $5 billion. With the Saudi "marker" oil price—now at $34 per barrel—set to be cut significantly soon, the country's current account will inevitably move into substantial deficit this year. If the marker price falls by $5.50 per barrel to $28.50, if oil output for the year averages 5.5 million b/d, and if imports are held to last year's level, the 1983 deficit will be at least $15 billion.

Oil, Commodity Prices, and Inflation

The sharp upturn in non-oil commodity prices in the past three months—after an almost continuous drop since late 1980—can be attributed in part to concern that rapid money growth, if sustained, will foster a renewed upsurge of inflation. Fears of an early reacceleration of inflation, however, have been allayed considerably by the intense price-cutting pressure on members of OPEC, helping to moderate any further commodity price increases in the near term.

Historically, commodity prices have been extremely sensitive to the level of economic activity and expectations of changes in the overall price level. Because the supply of many commodities is relatively fixed in the short run, any changes in demand will be quickly translated into price changes. Rising inflation expectations and low or negative real interest rates reinforce the demand for commodities because of expected inventory profits. For example, commodity prices soared more than 25% in 1979 when consumer prices accelerated to an increase of 13.3% and the economy was operating at a high level of capacity utilization.

During 1981-82 all of these forces were reversed. Because of high real interest rates, low overall capacity utilization, and falling inflation expectations, commodity prices tumbled by some 30%.

Although OPEC has attempted to behave like a cartel in setting prices, in the final analysis oil is just another commodity whose price is eventually responsive to forces of supply and demand. The recession weakened oil demand directly, while the price hikes of 1979-80 led to continuing conservation by oil-importing nations and higher production by non-OPEC members. These forces created surplus capacity within OPEC. With supply not an issue, users felt comfortable with drawing down inventories, aggravating the surplus situation.

It was not until late last year that spot oil prices began their slide. The fact that OPEC was able to resist a downward move in prices as long as it did is one measure of its market power. But OPEC has had difficulty reaching an agreement to restrict output sufficiently to support the official price. Thus, it is likely that oil will continue to be in excess supply for a while, which would impose further downward pressure on its price.

Given the normal time lags between money growth and overall price changes, however, inflation is not likely to be a problem at least until 1984. That could be just the time when the recovery and inventory restocking would sharply increase the demand for oil. OPEC might be able then to regain control over pricing decisions, thus worsening inflation expectations. In that case, the projected moderate price hikes for non-oil commodities would rapidly accelerate.

Douglas L. Bendt

Spotlight Back on M1?

In his March 8 testimony before the House Budget Committee, Federal Reserve Board Chairman Paul Volcker expressed concern that the money supply was growing "somewhat faster" than expected and that such growth might not be "compatible" with progress against inflation over the long-term. The statement was somewhat surprising to Fed-watchers. For although M1 has been growing at a furious pace for months—at a rate of about 14% since August—this is the first indication of official concern over the above-target performance.

Until now, Fed officials have maintained that the rapid growth in money was either technical in origin or the result of unusually strong demand for liquidity on the part of the public. On the first point, policy officials have suggested that the payment of interest on transaction accounts—specifically the "Super-Nows"—would, in all likelihood, result in an overstatement of M1 growth. However, evidence from an as-yet-unreleased Fed survey of banks reportedly suggests this may not be the case. The net effect of deposit flows induced by the introduction of both Super-Nows and the popular money market deposit accounts (MMDAs), apparently has *depressed* rather than stimulated the growth of M1. Although a portion of Super-Nows—which are accounted for in M1—came from non-M1 sources and did tend to speed M1 growth, the bulk originated from other M1 categories. And the funds flowing out of M1 into MMDAs more than offset those non-M1 funds coming into Super-Nows.

The Fed's second explanation of the over-target money growth has been that velocity—the relationship between money and GNP—may have changed. Because of uncertainty stemming from, among other things, concerns over future employment, individuals have temporarily increased their precautionary money balances. The Fed has thus been willing to tolerate "abnormal" growth in M1, under the assumption that the buildup in precautionary balances would be reversed, although the absence of any reversal so far now appears to have generated concern at the Fed.

Up to now, these two arguments have been used by the Fed to explain its shift in emphasis from M1 to the broader aggregates. Chairman Volcker indicated in his testimony before the Senate Banking Committee in February that M1 would become important only when it again became well-behaved. In reality, however, emphasis may have been changed not because the new aggregates made more economic sense, but because the Fed thought it had an increased likelihood of hitting its targets. This, in turn, provided a rationale for conducting a more expansionary monetary policy aimed at bolstering economic recovery.

Now, however—just as many analysts have become convinced that the Fed has completely abandoned its resolution to contain money growth—the surprising remarks by Chairman Volcker, on the heels of a spate of bullish economic news, may be a signal that a more-stringent policy is in the offing.

Robert S. Smith

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS: 6 months ending	EXPORTS: change from year earlier	GNP IN 1981: in billions of dollars	GNP IN 1981: $ per capita	BALANCE OF PAYMENTS: latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	MONEY AND BANKING: 12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars March 9, 1983	change from year earlier	current monetary conditions	COUNTRIES
Africa	Algeria	Agreement reached with Italy on the volume and price of gas exports from the Transmed Pipeline.	Nov.	−14%	36.0*	1,935	Jan.	2,230	−38%	0.9	0	Oil output averaged 702,000 b/d in 1982, down 13% from the previous year.	Dec. '80	+10%	May	+23%	.2141	− 6%	Foreign-exchange reserves fell $1.3 billion last year.	Algeria
	Angola	Investment policy to concentrate on rehabilitation and rationalization.	n. a.	—	3.9	525	n. a.	—	—	—	—	Export financing agreements should sustain level of essential imports.	n. a.	—	—	—	.0330	− 9%	Financial austerity continues.	Angola
	Egypt	Top priority given to new investment, restraint of non-essential import growth.	Sept.	−15%	30.8	710	Nov.	743	− 7%	1.2	57	Oil price cut again in February by $1-2 per barrel.	Nov.	+12%	Nov.	+24%	1.2100	0%	Money supply rising steadily.	Egypt
	Kenya	Economic growth—estimated at 3% in 1982—continues to slow; 2% growth projected for 1983.	May	− 9%	6.6	383	Jan.	189	−20%	1.2	337	No significant near-term improvement seen for balance-of-payments position.	Aug.	+24%	Nov.	+10%	.0850	−10%	Banks' liquid-asset requirement raised to 20%.	Kenya
	Liberia	IMF disbursed $33 million loan tranche March 3.	June	−17%	0.8	412	Nov.	14	+72%	0.4	160	Rubber and iron-ore exports continue to stagnate.	July	+16%	n. a.	—	Par	0%	Credit to private sector stagnates.	Liberia
	Libya	Budget for 1983 projects development outlays of $8 billion, down 8.9% from 1982 allocation.	Nov.	+69%	30.3	9,800	Dec.	7,060	−22%	17.7	0	Oil production averaged 1.15 mbd last year, up nearly 4% from 1981.	n. a.	n.a.	June	+ 0%	3.3770	− 1%	Foreign-exchange reserves fell by $1.94 billion last year.	Libya
	Morocco	France agrees to 1982 financial aid package of FF 1.8 billion, up from FF 1.4 billion last year.	Oct.	−15%	15.2	735	Dec.	218	− 5%	0.6	856	Tourists visiting Morocco last year numbered 1.95 mn., up 18.2% from 1981.	Nov.	+ 7%	June	+12%	.1570	−16%	State phosphate co. to borrow $25 mn. in eurocurrency mkt.	Morocco
	Nigeria	Manufacturers hard hit by expulsion of foreign labor, growing shortages of imported raw materials.	Nov.	+21%	86.8	1,125	Dec.	1,613	−59%	0.9	0	Imports fall as foreign-exchange shortages cause payments delays.	Sept.	+ 4%	Sept.	+ 5%	1.4976	− 2%	Reserves fall to one-month import cover.	Nigeria
	Senegal	New five-year plan to develop tourism, phosphates, and iron ore.	n. a.	—	2.3	400	Nov.	6	+12%	0.1	181	IDA backs oil exploration with $9.6 million loan.	Oct.	+16%	Sept.	+19%	.002928	−12%	Currently tight credit conditions expected to improve.	Senegal
	South Africa	Farmers hit by drought and falling prices.	Dec.	− 6%	77.5	2,573	Jan.	904	+54%	0.6	864	Fusion of financial and com'l rands ends capital controls over non-residents.	Dec.	+14%	Nov.	+21%	.9175	− 7%	Prime rate cut by 2 percentage points to 14%.	South Africa
	Sudan	Standard Oil of California will construct 900-mile oil pipeline to Red Sea.	June	−47%	9.0	482	Jan.	18	+ 3%	0.2	489	February donors' meeting pledged $750 mn.; $440 mn. to be disbursed rapidly.	Feb.	+14%	Nov.	+31%	.7601	−32%	Liquidity problems continue.	Sudan
	Zambia	Economy expected to stagnate this year, after estimated 5% contraction in 1982.	June	+15%	3.5	587	Nov.	45	−81%	0.5	622	Despite deteriorating plant, copper output has risen above 600,000-ton level.	June	+13%	Nov.	+ 9%	1.0686	− 3%	Kwacha devalued by 20% on January 7.	Zambia
	Zimbabwe	Restrictive policies, drought, and world recession expected to cause real GDP decline in 1983.	Aug.	−11%	6.7	870	Nov.	137	− 5%	1.1	0	Sharp cutbacks in private-sector currency allocations to trim imports.	Oct.	+18%	Aug.	+12%	1.0550	−24%	Inflation at mid-year expected to reach 25%.	Zimbabwe
Middle East	Jordan	Official economic growth target for 1983 is 8%, compared with about 9% last year.	June	+13%	4.5	1,341	Dec.	884	−19%	3.3	0	Industrial exports totaled $293 million in 1982 first half, 53% over year earlier.	Sept.	+ 7%	Nov.	+13%	2.8228	− 2%	Bank claims on government rising steadily.	Jordan
	Kuwait	Additional measures being implemented to alleviate stock-market problems.	Nov.	+ 1%	24.3	17,350	Jan.	5,576**	+39%	8.6	0	Oil output averaged 828,000 b/d last year, down 26% from 1981.	April	+ 7%	Nov.	+ 8%	3.4273	− 3%	Foreign-exchange reserves in 1982 rose by $1.85 billion.	Kuwait
	Qatar	Foreign partners selected for $5.6 billion LNG project to export gas from offshore North Field.	Nov.	− 8%	6.0	24,000	March	392**	+12%	2.9	0	Oil output averaged 828,000 b/d last year, down 26% from 1981.	n. a.	n. a.	March	+50%	.2747	− 8%	Claims on private sector rising steadily.	Qatar
	Saudi Arabia	SAMA officials suggest that accumulated foreign assets could be used to finance development outlays.	Nov.	−35%	155.8	16,719	Jan.	27,911**	−15%	2.4	0	Oil production averaged 6.45 mbd last year, down 34% from 1981.	March	− 1%	Sept.	+19%	.2906	− 1%	SAMA reiterates desire to limit riyal use in syndications.	Saudi Arabia
	United Arab Emirates	Actual federal budget deficit was $1.09 billion in 1982, 74% more than forecast.	Nov.	−20%	29.8	29,780	Oct.	3,111**	− 1%	4.1	0	Abu Dhabi oil output averaged 849,000 b/d last year, 25% below 1981.	n. a.	n. a.	Nov.	+ 6%	.2730	0%	New stock exchange may open in September.	United Arab Emirates

*1980 **excluding state reserves

World Interest Rates

market rates of March 9, 1983; bond yields as of March 4, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.38	11.00 intervention rate	11.50	9.50	5.00	19.00 penalty rate 22.00	4.00	4.50	5.50
Day-to-Day Money	8.375 March 10	10.00	11.00	8.55	12.875	5.80	19.00	4.625	4.00 1-month Euro-Swiss fr. rate	6.875
Treasury Bills 91-day, Middle Rates	8.26	9.20	10.75	12.25	n. a.	n. a.	17.452 77 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.35 finance paper 15% tax w/h	9.502	11.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.55	9.30 15% tax w/h	10.813	11.40 Certified	not traded	6.00	19.30	no market	3.875	no market
Government Bonds Long-term, new and old issues, average yield	10.62	12.17	10.75	10.51	14.02	7.50	18.78	7.62	4.25	7.262
Industrial Bonds prime, long-term, new and old issues, average yield	11.40 Aa Industrials	12.40	12.61	12.41	15.14	7.60	18.65	8.02	5.79	6.44
Bank Short-Term Rate (prime rate)	10.50	11.25	11.00	15.50	14.55	9.00	20.00 ⅛ qtrly fee on outstdng.	6.50	7.50	6.00
Bank Time Deposits 3-month	8.50 Cert. of Dep.	9.25	11.125	12.15	13.375	5.25	11.50	4.625 large deposits	1.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.3125	9.75	11.25	no market	38.50	5.3125	no market	4.75	3.625	6.875
Exchange Rates—in U.S.$ rates floating against the $	—	.8155	1.506	.0211	.1459	.4155	.0007	.3748	.4862	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.490 *D*	2.019 *D*	8.861 *D*	22.216 *D*	4.332 *P*	15.977 *D*	4.803 *P*	5.677 *P*	2.567 *P*

Eurodollar Deposits
(London, interbank, bid)
March 10

7-day	8.8125
1-month	9.00
3-month	9.125
6-month	9.8125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− 0.324
U.S.-Canada Treasury Bills	− 0.120
U.S.-Canada Finance Co. Paper	− 0.232
Eurodollars-U.K. Local Auth. Deposits	+ 0.394

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.00
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
426.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Jan.) 3.8	(Jan.) 8.3	(Jan.) 4.9	(Jan.) 9.6	(Feb.) 3.8	(Feb.) 15.1	(Jan.) 4.8	(Feb.) 2.3
Industrial production*	(Jan.) −3.2	(Nov.) −11.6	(Dec.) 1.3	(Dec.) −3.0	(Jan.) −1.9	(Dec.) −5.9	(Sept.) −8.0	(Jan.) −1.3
Trade balance† *(billions of local currency units)*	(Jan.) −$3.20	(Dec.) C$1.80	(Jan.) −£0.49	(Jan.) −FF9.58	(Jan.) DM2.70	(Dec.) −Lit.1,130	(Jan.) −SF0.63	(Jan.) −¥144.8
Money supply (M1)*	(Jan.) 7.5	(Jan.) 7.8	(Dec.) 11.0	(Sept.) 10.8	(Dec.) 6.8	(Oct.) 15.1	(Nov.) 12.1	(Nov.) 5.0
Velocity of money (M1)*	(Dec.) −4.8	(Sept.) 1.1	(Sept.) −4.7	(June)** 2.2	(Sept.) −3.1	(Sept.)** 2.8	(March)** 9.3	(Sept.) 0.1
Reserves minus gold *($ million, change from previous month)*	(Jan.) −20	(Jan.) 330	(Jan.) −1,559	(Jan.) 2,945	(Jan.) 1,395	(Jan.) 1,149	(Jan.) −2,689	(Jan.) 329

* Percent change from 12 months earlier. ** based on GDP. † Figures are only for the month indicated

Adjusting to Lower Oil Prices

The intrigue surrounding world oil prices goes on. OPEC is now in its third month of disarray over what to do about its weakening grip on the lion's share of the global oil market. The optimism of some members of the cartel that an accord on prices and production would be reached quickly has faded. And about the only thing that is certain is that prices are bound to come down. How far they will fall, at this point, is virtually anybody's guess.

A significant decline in oil prices would have measurable effects—both direct and indirect—on essentially every region of the world. But because these effects would pull in different directions and with uncertain magnitudes, the overall impact is difficult to estimate in precise quantitative terms. Nevertheless, tracing the effects of a hypothetical price drop on world economic growth, inflation, interest rates, and changes in international financial balances can provide useful insights for the future.

Perhaps even more important in evaluating the ultimate impact, however, is an awareness of the changes that are already under way—in global saving and capital investment, for example—in anticipation of the oil-price fall. For as fascinating as the OPEC-price drama might be, the world economy is not waiting to see how it is played out; the transition to lower oil prices has already begun. Furthermore, the reactions of policymakers to changes in the economy during this period of transition will be critical to the long-term economic outlook.

Global consequences

While the magnitude and the timing of the oil-price drop is still unknown, it is possible to gain useful information about its impact by choosing a specific lower price and estimating the effects it would have on the international economy. Chase has calculated the impact on different regions of the world of a 20% decline in the price of oil (a drop of around $6 from the current "marker" price of $34 per barrel for Saudi Arabian light crude). Abstracting from possible financial disruptions that could occur during an abrupt transition to a lower price path, the study indicates that such a decline would bolster the global economic recovery and result in significantly lower inflation and interest rates at least through the mid-1980s. These advances, in turn, would bring a marked improvement to international payments balances for many areas of the world.

For example, real growth in the 24 member countries of the OECD would accelerate, on aggregate, between one-half and three-quarters of a percentage point over the period 1983-85. In addition, annual increases in inflation, as measured by GDP deflators, would be about one percentage point less than might have been expected without the oil-price decline. Partly because of the reduced inflation, short-term interest rates would also be likely to be about 100 basis points lower in late 1983 and in 1984.

The table below illustrates the effects of such an oil-price break on the OECD current account. In 1982, OECD net imports of fuels came to approximately $225 billion. Based on this figure, the initial stimulus to these industrialized economies of a $6-per-barrel price drop would be approximately $45 billion. The combination of the lower price and the stepped-up economic activity would undoubtedly lead to an increase in the *volume* of OECD oil imports. However, because of the continuing effects of energy conservation and interfuel substitution, the boost in the demand for OPEC oil would probably be held to 1%-2%. Among the other effects the OECD economies could expect would be: a loss of revenues from exports to the OPEC countries as they adjusted to lower incomes; an increase in the volume of imports of raw materials and manufactured goods from the centrally planned economies (CPEs) and non-oil developing countries (NODCs); and lower net revenues from services and investment income. The industrialized countries could also expect a modest rise in exports to the NODCs, as lower oil prices freed up their scarce resources for other uses. For the OECD as a whole, the net effect of this hypothetical price decline in 1983 would be a $13-billion improvement in the current account from what it might have been without the oil-price break.

For some of the other regions of the world, the current-account effects of a 20% price drop would be even greater, as the table on the next page shows. For OPEC, the offsets to the initial oil-revenue loss are smaller than those for the OECD. This is because net investment income is also curbed by lower interest rates and reduced OPEC assets as oil producers finance their current-account deficits by spending out of reserves and by borrowing in the capital markets.

For the centrally planned economies, the major

Annualized impact of an oil-price break on the OECD current account

	$ billions
Initial oil-price effect on fuel imports (20% drop in $225 billion flow)	+45
Higher volume of oil imports (consumption plus restocking)	− 8
Lower revenues from exports to OPEC (10% drop in $120 billion flow)	−12
Higher volume of imports from NODCs and CPEs (5% increase in $200 billion flow)	−10
Lower revenues from services and investment income	− 5
Higher exports to NODCs	+ 3
Net effect on OECD current account:	+13

Adjusting to Lower Oil Prices (continued from page 7)

losses stemming from the fall in oil prices would be absorbed by the energy exporters—the Soviet Union and China. Such losses should not entail any major program adjustments, however, since in these countries, reserves are high and debts are low. The gains from expanded OECD imports and lower interest costs, on the other hand, would accrue mainly to Eastern Europe.

For the non-oil developing countries, the initial impact on economic growth is relatively modest. Although higher OECD demand for exports provides some boost, the effect in 1983 would probably be limited to a rise in GDP of no more than one-quarter of a percentage point on average. However, the current accounts of the NODCs would also benefit from reduced interest payments. And in 1984, the combination of higher OECD growth and lower oil prices could stimulate a strong recovery for at least some of these developing countries. By 1985, overall real growth in the NODCs could recover to around 4.5%.

Saving and investment

A swing in the regional current accounts of the magnitude suggested by the table is much smaller than the shift experienced during the last oil shock of 1979-80 and smaller than the annual swings in 1981-82. Still, some analysts have expressed concern over the shift of current income from regions with a high rate of saving (the Arab Gulf) to regions with low savings rates (the United States and Europe). Some have even suggested that there could be a fall in global savings that would place upward pressure on interest rates—both nominal and real. Such analyses, however, implicitly assume no adjustment in global real production and ignore the actual experience of 1979-81. The stimulative effects of a lower path for oil prices would generate sufficient savings in the global economy. Furthermore, a greater proportion of that saving would be done by oil-consuming individuals, corporations, and governments whose portfolios would contain a higher share of real productive assets.

Sustained economic growth beyond 1984-85 depends in part on the net effect of lower oil prices on capital investment. Expectations of an oil-price drop are already generating economic changes that will inevitably affect capital spending—both positively and negatively. On the negative side, increased price uncertainty, a reversal in the criteria for judging plant obsolescence, and changes in the average scale of capital projects may act to reduce global capital investment for at least a transitional period.

Offsetting these primarily negative influences, however, are several influences favorable to increased capital spending. Most important, expectations of a more rapid recovery in the OECD and the prospect of sustained real growth through the mid-1980s should eventually boost capital expenditures significantly. Depending on what ultimately happens to interest rates and global saving, after a transitional period of perhaps six months to a year—in which capital investment may actually be less than if oil prices had held steady—a strong investment surge can be expected for 1984-85.

The shift in financial balances associated with an oil-price break should not by itself seriously affect international financial flows and world liquidity. However, a rapid transition with funding dislocations felt by various large commercial banks, together with uncertainty about the eventual magnitude of the shift in relative prices, could prompt individual commercial banks to contract their lending. Throughout the international capital markets, there would be intensified scrutiny of banks' asset quality and funding positions from correspondent banks, national regulators, and bank shareholders.

In that situation, mismanagement by central banks that allowed a contraction in world liquidity could be quite damaging to the international financial system. It is encouraging, though, that when the world's central bankers were presented with a similar test during the fall of 1982, they made correct decisions to sustain liquidity and confidence.

Consequences of an oil-price break on regional current accounts in 1983

($ billions)

	OECD	OPEC	NODC	CPE	TOTAL*
Current account: Initial projection	−30	−15	−53	−2	−100
Initial oil-price impact	45	−45	4	−4	
Oil volume effect	− 8	8	0	0	
Non-oil net exports	−19	15	3.5	0.5	
Services and investment income	− 5	− 3	7.5	0.5	
Current account: New projection	−17	−40	−38	−5	−100

* The world current-account discrepancy was in the range of $90 to $100 billion in 1982. The areas where the largest discrepancies arise are in non-factor services, investment income, and official transfers. The offset to these balances aggregated over country data accrues largely to private individuals and businesses.

After a transition to lower oil prices in the mid-1980s, it would be appropriate for world monetary growth to slow down. At that time, the money demand increases associated with higher real growth would be offset by the lower growth in global price levels. Since 1980, the operation of OPEC—and Saudi Arabian production policy in particular—has kept world oil prices in terms of current dollars quite high, while other prices of non-fuel commodities and manufactured goods have actually fallen. This price rigidity in the oil market tended to concentrate the deflationary impact of slow money growth on other markets during the global recession. A break in oil prices in 1983 that persists through mid-decade, would, in turn, concentrate the stimulative effects of recent rapid world money growth on those other markets. *Donald W. Green*